KERR-MCGEE CORP.

IBLA 87-288, 88-219, 88-489 Decided December 12, 1988

Appeals from decisions of the Director, Minerals Management Service, requiring payment of additional royalties on gas produced from oil and gas lease M-18951 (ND) (MMS-83-0033-O&G and MMS-87-0344-O&G) and an appeal from a decision of the Director affirming an order assessing late payment charges. MMS-88-0011-O&G.

Set aside and remanded.

1. Oil and Gas Leases: Royalties

Where the Director, Minerals Management Service, issues decisions purporting to value gas production from an onshore oil and gas lease for royalty purposes in accordance with the regulations at 30 CFR 206.105, but the record shows that during part of the valuation period the standards in Notice to Lessees and Operators No. 5 were also applicable, and during the remainder of the period, valuation was controlled by an act of Congress (Notice to Lessees Numbered 5 Gas Royalty Act, P.L. 100-234, 101 Stat. 1719 (1988)), passed subsequent to the Director's decisions, the Board may remand the cases to the Director for reconsideration of the proper valuation based upon the regulations in 30 CFR Part 206, Secretarial interpretations thereof, NTL-5, and the act of Congress.

APPEARANCES: Johnny J. Akins, Esq., Oklahoma City, Oklahoma, for appel-lant; Peter J. Schaumberg, Esq., Howard W. Chalker, Esq., Geoffrey Heath, Esq., Susan K. Hoven, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE HARRIS

Kerr-McGee Corporation (KM) appeals from three separate decisions of the Director, Minerals Management Service (MMS), concerning valuation of wet gas (casinghead gas) for royalty purposes. The gas in question was produced from KM's Federal Well No. 1-22 which is located on KM's Federal lease No. M-18951 (ND), in McKensie County, North Dakota. Two appeals con- cern virtually identical questions of fact and law relating to valuation; the third involves late payment charges for additional royalty based on one of those valuation decisions. All three were consolidated by order dated July 12, 1988.

As the result of an audit for the period from September 1981 through December 1982, the Regional Manager, Lakewood Regional Compliance Office, MMS, issued a decision on December 27, 1983, requiring KM to pay additional royalties on gas production in the amount of $142,064.44. The basis for MMS' conclusion that additional royalties were due was its determination that royalties should have been computed to "reflect [Natural Gas Policy Act] Section 102 prices for the casinghead gas at the wellhead adjusted for its Btu content" (Order at 1).

KM appealed to the Director, MMS, who in a decision dated November 6, 1986, affirmed the imposition of additional royalties but reduced the amount to $90,430 on the basis that the proper valuation of the gas production "can be determined by applying the regulations applicable specifically to wet gas in 30 CFR | 206.105" (Decision at 6). The Director's decision was timely appealed to this Board and assigned docket number IBLA 87-288.

A similar audit, concerning the same well but involving the period from January 1983 through December 1984, resulted in the issuance by the Chief, Royalty Compliance Division, MMS, of an order dated August 14, 1987, requiring the payment of additional royalties in the amount of $44,692.82. His rationale for the order was consistent with the Director's November 6, 1986, decision. KM timely filed an appeal with the Director, MMS, who affirmed the decision on December 2, 1987. KM's appeal to this Board was timely filed and docketed as IBLA 88-219.

On November 10, 1987, the Chief, Royalty Compliance Office, MMS, issued an order requesting the payment of late payment charges in the amount of $22,098.67 arising from the alleged additional royalties due for the period from January 1983 through December 1984. Appeal of those charges was denied by the Director, MMS, by decision of March 16, 1988. KM filed a timely appeal and docket number IBLA 88-489 was assigned.

Federal Lease M-18951 (ND) provides:

> This oil and gas lease is issued for a period of ten (10) years to the above-named lessee pursuant and subject to the provisions of the Mineral Leasing Act and subject to all rules and regulations of the Secretary of the Interior now or hereafter in force, when not inconsistent with any express and specific provisions herein, which are made a part hereof.
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> * * * * * * *
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> Royalty on production. (1) To pay the lessor 12 1/2 percent royalty on the production removed or sold from the leased lands computed in accordance with the Oil and Gas Operating Regulations (30 CFR Pt. 221).
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> (2) It is expressly agreed that the Secretary of the Interior may establish reasonable minimum values for purposes of computing royalty on any or all oil, gas, natural gasoline, and other pro- ducts obtained from gas, due consideration being given to the

> highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters and, whenever appropriate, after notice and opportunity to be heard.

Gas from the well on the lease is sold and delivered to Koch Hydrocarbon Company (Koch) at or near the wellhead. Koch processes and sells the gas pursuant to a Casinghead Gas Processing Agreement dated April 15, 1981. In relevant part, the agreement provides that:

> Section 7.1 The price to be paid by Processor to Producer shall be an amount equal to seventy percent (70%) of the net sales proceeds received for the liquefiable hydrocarbons, residue gas and sulfur saved and sold which is attributable to Producer's gas as determined in Article V hereof, less the fees attributable thereto.

Thus, under the contract Koch paid KM 70 percent of its net sales proceeds at the tailgate of the processing plant from sales of dry residue gas and extracted products. KM paid royalty on the actual amount received from Koch.

The issue herein concerns the method of determining the value of gas production for purposes of calculating the appropriate royalty. KM valued production for the relevant periods based on its actual proceeds from Koch, while MMS valued production based on the value of the residue gas and other components at the tailgate in accordance with the regulations.

The valuation of gas production for purposes of royalty calculation is addressed in 30 CFR 206.103, 30 CFR 206.105, and 30 CFR 206.106. 1/ 30 CFR 206.103 reads as follows:

1/ Effective Mar. 1, 1988, the Department completely revised the regula- tions in 30 CFR relating to gas valuation for royalty purposes. 53 FR 1230 (Jan. 15, 1988). We note that in that rulemaking the Department specifi- cally examined the question of valuation under percent-of-proceeds con- tracts. The Department promulgated separate regulations to cover valuation standards for unprocessed gas (30 CFR 206.152, 53 FR at 1274) and for pro- cessed gas (30 CFR 206.153, 53 FR at 1276). The unprocessed gas regulation, 30 CFR 206.152, specifically states that the processed gas regulation, 30 CFR 206.153, shall apply when the wet gas is sold under a percent-of-proceeds contract. 53 FR at 1274. Under the processed gas regulation, valuation for royalty purposes is to be determined based on the combined value of the residue gas and all gas plant products (less certain allow- ances). 30 CFR 206.153(a)(2). References in this decision to gas valua-tion regulations are to the regulations in effect during the relevant periods in dispute unless otherwise noted.

| 206.103 Value basis for computing royalties.

The value of production, for the purpose of computing roy- alty, shall be the estimated reasonable value of the product as determined by the Associate Director due consideration being given to the highest price paid for a part or for a majority of produc- tion of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters. Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price per barrel, thousand cubic feet, or gallon paid or offered at the time of production in a fair and open market for the major portion of like-quality oil, gas, or other products produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value.

In this case KM sold its wet gas at the wellhead under an arm's-length contract with Koch. The compensation to KM for the sale was a percentage of the proceeds of Koch's sale of the dry residue gas and extracted products. KM argues that the method of valuation utilized by MMS does not result in a "reasonable value of production" and that it fails to give due considera- tion, as required by 30 CFR 206.103, to "the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessees, to posted prices, and to other relevant matters." KM's position is, in essence, that MMS is limited in its valua- tion of gas for royalty purposes to a reasonable value and that its percent-age of proceeds contract represents that reasonable value.

MMS responds by arguing that the method of valuation it utilized is mandated by its interpretation of all of the relevant regulations, although it points to 30 CFR 206.105 as specifically controlling the valuation of wet gas. That regulation provides:

| 206.105 Royalty on gas.

The royalty on gas shall be the percentage established by the terms of the lease of the value or amount of the gas produced.

(a) Royalty accrues on dry gas, whether produced as such or as residue gas after the extraction of gasoline.

(b) If the lessee derives revenue on gas from two or more products, a royalty normally will be collected on all such products.

(c) For the purpose of computing royalty, the value of wet gas shall be either the gross proceeds accruing to the lessee from the sale thereof or the aggregate value determined by the Secretary of all commodities, including residue gas, obtained therefrom, whichever is greater.

30 CFR 206.106 in relevant part provides:

| 206.106 Royalty on casing-head or natural gasoline, butane, propane, or other liquid hydrocarbon substances extracted from gas.

A royalty as provided in the lease shall be paid on the value of one-third (or the lessee's portion if greater than one-third) of all casing-head or natural gasoline, butane, propane, or other liquid hydrocarbon substances extracted from the gas produced from the leasehold. The value of the remainder is an allowance for the cost of manufacture, and no royalty thereon is required.

[1] Section 17 of the Mineral Leasing Act, as amended, 30 U.S.C. | 226 (1982), provides for the assessment of royalty "in amount or value of pro- duction removed or sold from the lease." The statute does not set forth any particular method for valuing production removed or sold from a Federal oil and gas lease. However, it is well settled that the Secretary of the Interior has "considerable latitude" in determining the value of oil and gas production as a basis for computing royalties. Hoover & Bracken Energies, Inc., 52 IBLA 27, 33 (1981), rev'd, Hoover & Bracken Energies, Inc. v. United States Department of the Interior, No. 81-461-T (W.D. Okla. Nov. 18, 1981), rev'd, 723 F.2d 1488 (10th Cir. 1983), cert. denied, 469 U.S. 821 (1984). Departmental rules relating to the valuation of gas for royalty purposes have been in existence seen 1920. In that earliest promulgation of applicable regulations, the Secretary provided that the value of "casing-head gas" would be either one-third of the value of marketable casing-head gasoline extracted from the gas or the price received by the lessee for the casing-head gas if higher than the equivalent of the one-third value. 47 L.D. 552, 555 (1920).

The Secretary revised those regulations in 1926. 52 L.D. 1 (1926). In section 4(c) of the revision, the Secretary indicated that royalty would be due on 100 percent of the "dry gas" produced, whether produced as dry gas from the well or as residual dry gas from a plant after natural-gas gasoline had been extracted. Id. at 10-11. He also provided in section 4(d) that royalty would also be due on one-third of the value of the marketable natural-gas gasoline extracted, the "remaining two-thirds being allowed to the lessee for the cost of manufacture." 2/

2/ The regulations explained:

"Natural-gas gasoline (also known as casing-head gasoline) is a manu- factured product. The value of this product is contingent upon the value of the raw material and the cost of its manufacture. The Government does not wish to collect royalty on that part of the value which is derived from the

The Secretary further provided:

> In general, where natural gas is delivered or sold for purposes of extracting gasoline, two separate commodities are involved -- the natural-gas gasoline and the dry residue gas.
> If, however, the lessee receives a higher price for such natural gas as a single commodity than the combined value of the two commodities, the natural-gas gasoline and the dry residual gas, as fixed by the Secretary of the Interior, the Government royalty shall be computed on natural gas alone and at the higher price received therefor by the lessee.

Id. at 11. Thus, the Secretary determined by regulation that royalty would be required on the greater of the price received for the wet gas as a single commodity, if sold on that basis, or the combined value of the dry residual gas and one-third the value of the natural-gas gasoline extracted.

In 1936, the Secretary published the oil and gas regulations in the Federal Register. 1 FR 1996 (Nov. 20, 1936). Regarding royalty on gas and casing-head gasoline, the regulations provided that royalty on dry gas would accrue whether produced as such or as residue gas after the extraction of gasoline. The value of wet gas for the purpose of royalty, according to section 3(g) of those regulations, was to be "either the gross proceeds accruing to the lessee from the sale thereof or the aggregate value deter- mined by the Secretary * * * of all commodities, including residue gas obtained therefrom, whichever is greater." 1 FR at 2001. For casing-head or natural gasoline, the regulations stated at section 3(h) that royalty "shall be paid on the value of one-third (or the lessee's portion if greater than one-third) of all casing-head or natural gasoline extracted from the gas produced from the leasehold. The value of the remainder is an allowance for the cost of manufacture, and no royalty thereon is required." Id.

Subsequently, in Instructions dated June 7, 1937, the Acting Secretary provided an interpretation of the 1926 regulations regarding the calcula-tion of royalty on gas and derivative products. 56 I.D. 462 (1937). The instructions stated that the interpretation was necessary because improved processing equipment and methods, as well as conditions on some leases, resulted in the two-thirds manufacturing allowance being excessive in some cases. The Acting Secretary stated that "a lessee's natural gas production can not be valued for royalty purposes at less than the net amount which the lessee actually realizes from his current disposals of such natural gas in the field." 56 I.D. at 464. He instructed the Director of the Geological

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fn. 2 (continued)
cost of manufacturing, inasmuch as the Government's equity is confined to the value of the raw material involved. In computing royalty on natural-gas gasoline the value of the raw gasoline in the natural gas as produced is assumed to be one-third the value of the marketable natural-gas gasoline extracted from such gas, the remaining two-thirds being allowed to the lessee for the cost of manufacture."
Id. at 11.

Survey (GS), in computing royalties, to charge lessees "either on the basis of the combined value" of the natural gas and derivative products "as mea- sured by the lessee's gross field realizations less his actual extraction costs (net field realization value), or on the basis of the section 4(d) formula [the two-thirds manufacturing allowance], whichever may result in the higher valuation." 56 I.D. at 465. 3/

The Secretary republished the 1936 oil and gas regulations, effective June 1, 1942, with only minor changes, and they were codified in the Code of Federal Regulations at Title 30. 7 FR 4132 (June 2, 1942). Those regu- lations remained in effect, virtually unchanged, except for CFR section numbers, until 1988 (see note 1, supra). Thus, from early on the Depart- mental regulations in 30 CFR provided for collection of royalty on wet gas based on the greater of the lessee's proceeds from the sale of wet gas, if it was sold that way, or the combined value of the dry residue gas after processing and one-third of the liquids extracted (or more than one-third, if the lessee's share was greater than one-third).

Despite the consistency in the regulatory language, the Department, through the Conservation Division, GS, and later MMS, indulged in various valuation methods. Thus, on January 29, 1947, the Director, GS, issued a decision in memorandum form to the Secretary, describing the inequities of applying a literal interpretation of the regulations in the situation where the processors retained a portion of the dry gas residue as a manufacturing allowance. Under the contracts at issue in those cases, the lessee received 75 percent of the dry residue gas and 50 percent of the extracted liquids. Twenty-five percent of the gas and 50 percent of the liquids were retained by the processor. The Director explained:

> The 1926 regulations [52 L.D. 1 (1926)] as interpretated [sic] by the instructions of June 7, 1937 [56 L.D. 462 (1937)], applied to the case here under consideration, would provide for a royalty computed on 75 per cent of dry residue gas and 50 per cent of liquids allocated to the producer at the prices actually received, with a minimum based on one-third of the gasoline and 100 per cent of the salable residue dry gas at the prices actually received, but at not less than any minimum prices established by the Secretary. A literal interpretation of the 1936 regulations and the succeeding regulations of June 1, 1942, 30 C.F.R. 221, under the same circumstances require computation of royalty on the basis of 100 per cent of the salable residue dry gas and, because of the inclusion of the parenthetical phrase "or the lessee's portion if greater than one-third" in section 221.42 of the 1936 regulations and section 221.52 of the 1942 regulations, on the basis of 50 percent of the liquids.

3/ These instructions were based on the 1926 regulations. There is no mention in the instructions of the 1936 regulations, and therefore, no acknowledgment that the 1936 regulations had modified the 1926 regulations by increasing the portion of the natural gas gasoline production upon which royalty would be due from the value of one-third thereof to the value of one-third or the lessee's portion, if greater than one-third.

> As previously explained, the above-mentioned sections of the 1936 and 1942 regulations are based on the faulty premise that the cost of manufacture will always be reflected in the retention by the processor of a portion of the extracted liquids only and in the cases here under consideration where the cost of manufacturing is expressed in the retention by the processor of both gas and liquids, it is apparent that certain inequities in royalty compu- tation have resulted. Application of the principles expressed in the Acting Secretary's instructions of June 7, 1937, to the 1936 and 1942 regulations would eliminate any such inequities in the computation of Federal royalty on natural gas and its derivative products.

(Decision at 3). He recommended

> that in computing royalties due the United States on natural gas, including its derivative products, produced from any Federal oil and gas lease that such royalty be computed on one of the follow- ing bases, whichever results in the greater royalty, whenever it appears to the satisfaction of the Geological Survey that the cost of manufacture is effected in both gas and liquids retained by the processor.
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> 1. The basis of the gross market value of all such products less extraction cost; or on
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> 2. The basis of one-third of the gasoline, butane, propane, and other liquid substances extracted from the gas and all of the residue dry gas available for sale at not less than the estab- lished minimum prices. If no minimum prices have been established, the market value obtainable by the lessee shall be used.

(Decision at 4). Acting Secretary Chapman approved that decision on February 28, 1947.

GS thereafter apparently adopted that valuation method. The 1974 Conservation Division Manual (CDM), GS, states:

> As stated in 30 CFR 221.50 [30 CFR 206.105 (1986)] and 221.51 [30 CFR 206.106 (1986)], royalty shall be based on the value of one-third (or the lessee's portion if greater than one-third) of all liquids extracted from the gas plus 100 percent of the residue gas. This regulation assumes that the cost of manufacturing is reflected by the plant operator retaining only liquids. How- ever, existing regulations do not take into consideration those instances where a portion of the manufacturing allowance for pro- cessing liquids is reflected in the residue gas retained by the plant operator. Royalty settlement in such instances may be based on the larger value derived from either (1) gross proceeds to the lessee, (2) 100 percent of the residue gas plus a flat one-third of the liquids, (3) a gross value of all products less plant extraction costs.

CDM 647.3.3C (1974).

In 1977, GS abandoned this earlier policy of gas valuation in favor of a new policy, again without any change in the regulations in 30 Code of Federal Regulations. In CDM Release No. 35, dated August 15, 1977, the Director, GS, stated that the Manual was being revised "to implement the requirements of NTL [Notice to Lessees and Operators]-5." NTL-5, which had an effective date of June 1, 1977, stated:

> In recognition of the increasing value of natural gas, greater acceptance of the Btu method for gas settlement, and the need to assure the receipt of the fair market value for gas produced from leases under its jurisdiction, the Geological Survey concluded it was necessary to modify its procedures for determining the value of natural gas for royalty computation purposes.

42 FR 22610 (May 4, 1977).

The CDM summed up the changes as follows:

> [T]he general policy of the Geological Survey is that, effective June 1, 1977, royalty values will be based on the higher of:
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> (1) The volume, Btu content and value of the gas at the lease in accordance with the guidelines contained in this chapter; or
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> (2) The gross proceeds accruing to the lessee from the sale or other disposition of the gas; or
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> (3) 18 cents per Mcf at 60~F. and 14.73 psia, subject to Btu and other appropriate adjustments described in this chapter.
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> Where production prior to June 1, 1977, had been improperly valued for royalty purposes, any retroactive adjustment of such royalty values shall be made based on the guidelines which were effective for such period, e.g., net realization, highest price paid for a majority of production, etc., as appropriate. In other words, based on the principle that corrected interpretations are to be applied prospectively from the date of Notice, the guide- lines contained in NTL-5 are not applicable to production prior to June 1, 1977.

CDM 647.2.3A (1977).

Thereafter, MMS, effective August 1, 1986, modified NTL-5 to provide simply that royalty value would be determined "pursuant to 30 CFR Part 206." 51 FR 26759, 26765 (July 25, 1986). It explained that "NTL-5 as amended * * * refers to all of 30 CFR Part 206, not just 206.103. Thus, wet gas will be valued in accordance with the provisions of 206.105 and 206.106 and other provisions in Part 206, as applicable." 51 FR at 26761. MMS stated in the notice that the modification would be applied prospectively (51 FR at 26761). However, on January 6, 1988, Congress found it necessary, due to inequitable situations, to provide, through legislation, for certain retroactive adjustments in the valuation of gas for royalty purposes. It therefore enacted the Notice to Lessees Numbered 5 Gas Royalty Act (NTL-5 Act). P.L. 100-234, 101 Stat. 1719 (1988). 4/ Section 3(a) of that Act stated that the value for royalty purposes of any gas production from Fed- eral onshore or Indian leases during the period January 1, 1982, through July 31, 1986, which was subject to NTL-5, would be computed in accordance with section 3(b) of the Act. That section provides:

> (b) ROYALTY CALCULATION FOR CERTAIN FEDERAL ONSHORE AND INDIAN OIL AND GAS LEASES.--If the gas referred to in subsection (a) of this section was produced from a Federal onshore or Indian lease, the value of production for the purpose of computing roy- alty, shall be the reasonable value of the product as determined consistent with the lease terms and the regulations codified at part 206 of title 30, Code of Federal Regulations in effect at the time of production. In establishing the reasonable value, due consideration shall be given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters. Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price per thousand cubic feet or gallon paid or offered at the time of production in a fair and open market for the major portion of like-quality gas, or other products produced and sold from the field or areas where the leased lands are situated will be considered to be a reasonable value. [5/]

101 Stat. at 1720.

The first sentence of that section states that gas valuation shall be the reasonable value of the product, as determined by the regulations in 30 CFR Part 206. The next two sentences are essentially a quote of 30 CFR 206.103.

Thus, for the time periods in question in this case (September 1, 1981, through December 31, 1982, in IBLA 87-288, and January 1, 1983, through December 31, 1984, in IBLA 88-219) different methods of valuation are applicable. From September 1 through December 31, 1981, the regula-tions in 30 CFR Part 206 and NTL-5 are the proper guidelines, while for the remainder of the relevant time period (January 1, 1982, through December 31, 1984), section 3(b) of the NTL-5 Act controls.

4/ Congress specifically found in section 1(b) of the act that NTL-5 and the 1986 modification thereof were duly promulgated regulations of the Department. 101 Stat. at 1719.

5/ In the Department's 1988 revision of the gas valuation regulations (see note 1, supra), NTL-5 was terminated. 53 FR 1272 (Jan. 15, 1988).

Therefore, it is clear that MMS was not bound, as appellant claims, to accept the contract price as the reasonable value of the gas production. However, what is not apparent to us, based on the present record, is whether MMS's valuation for the periods in question is in accordance with the applicable valuation standards set forth above. Since NTL-5, as originally promulgated, was effective during part of the period involved in IBLA 87-288, valuation for that time should have reflected consideration of that standard. Subsequent time periods in the appeals, as stated above, are governed by an act of Congress which was not in existence at the time the Director made his valuation determinations in this case. Although it appears that the Director's valuation comported with the NTL-5 Act to the extent he found the regulations in 30 CFR Part 206 controlling, we believe the best course of action in these appeals is to allow the Director to determine in the first instance whether his valuations are in accordance with that Act. Therefore, we set aside the Director's decisions in all three of these appeals to allow him to reconsider whether his valuations in these cases in light of our discussion of the history of the gas valuation regulations, including the Secretarial interpretations thereof, 6/ NTL-5, and the NTL-5 Act. 7/ Should the Director again issue decisions in these cases, he should set out with specificity the method of valuation used, and the legal basis for applying that valuation.

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decisions appealed from are set aside and remanded for action consistent with this opinion.

Bruce R. Harris
Administrative Judge

I concur:

John H. Kelly
Administrative Judge

6/ Since this case involves the retention of a percentage of the dry resi- due gas, as well as a percentage of the extracts, by the processor, the Director should consider whether the 1947 decision approved by the Acting Secretary has any relevance to valuation in this case.

7/ We set aside the late payment decision (IBLA 88-489) only because it is based on an additional royalty amount which has not yet been determined.